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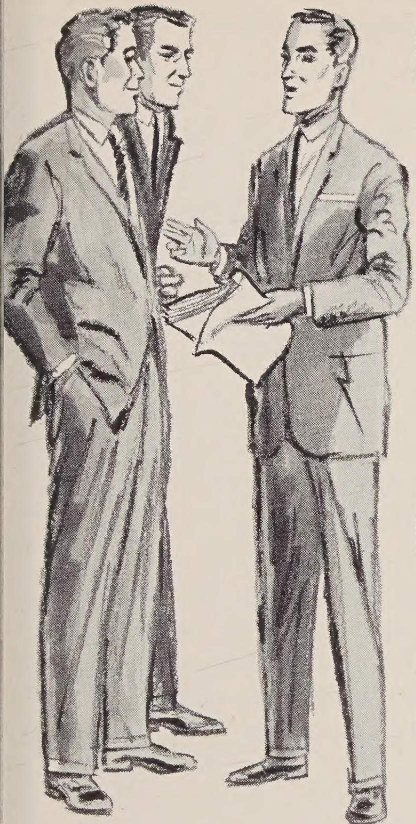

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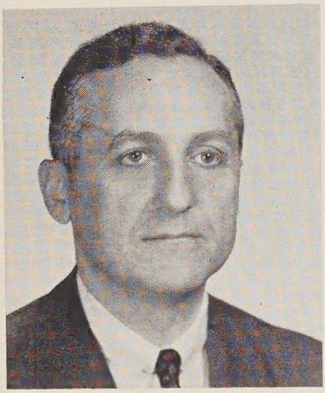

One of the principal activities planned for the Society by the Board of Directors for 1960-61 is a program designed to curtail and eliminate substandard reporting. Wherever substandard reporting exists, it casts a reflection upon the profession as a whole and remains as a latent bomb which may at some time explode and destroy the practitioner who brought it into being.

The incidence of substandard reporting is too widespread to be ignored and the profession must bestir itself to meet the issue. Oliver Herford once said, "The crab, more than any of God's creatures, has formulated the perfect philosophy of life. Whenever he is confronted with a great moral crisis in life, he first makes up his mind what is right, and then goes sideways as fast as he can." Our course of action must be more forthright.

The standards of reporting enunciated by the AICPA committee on auditing procedure require, briefly, that an opinion be expressed on the conformity of financial statements with generally accepted principles of accounting and on the consistency in the application of these principles, that adequate informative disclosures be made, and that an opin-

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ion be expressed or denied regarding the statements taken as a whole together with the reasons for denial where an opinion cannot be expressed. The report should also contain a clear indication of the character of the auditor's examination and the degree of responsibility he assumes.

These standards have been in print long enough so that professed ignorance of their existence would seem to be almost inexcusable, yet knowledgeable bankers have complained that they still keep getting audit reports which contain no opinions or denials of opinions; which contain "clean" opinions where substantial inventory figures are submitted solely on the basis of management "certifications"; and which in other significant respects fail to comply with the basic requirements of the announced standards. Aside from the damage to professional repute which is likely to attend disclosure of substandard reporting, there always lurks in the background the spectre of legal liability where injury results from reliance upon substandard reports.

Our Society program, which is now being shaped up in certain joint committee action, includes, among other things, plans for panel discussions and educational articles with the active co-operation of bankers in which disguised "living examples" may be used to point up dramatically the violations of reporting standards which happen too often.

A writer in a professional accounting journal said recently, "....it is well recognized that substandard reports almost never result from wilful violation but rather from lack of knowledge or experience." This is a charitable view which cannot go on for an unlimited time. It behooves us to exert every effort within our own ranks to dissipate this lack of knowledge if it exists. To that end each of us should expose himself to, and participate in, the Society's program as fully as he can during the coming year.

An eminent accountant reviews the changes in the fiscal controls and financial management in the State of Illinois

Progress in Illinois State Fiscal Improvements

y Lloyd Morey

About four years ago, a serious de-lcation on the part of the elected cumbent of the constitutional office Auditor of Public Accounts of linois shocked the citizens of the ate and the entire country. As a sult of that incident, important gislation was passed by the 70th 957) General Assembly to correct me of the conditions helping to make ch a thing possible.[1] These actions ere based largely on a review and commendations presented by the riter, Albert B. Jenner, Jr., and hn S. Rendleman, with assistance Eric L. Kohler, CPA.

A short time ago, a final accounting d settlement was made of state nds wrongfully disbursed by the ficial concerned.[2] With this phase the episode now history (except r the completion of penitentiary ntences now being served by the incipal and two others), it is appro-iate to review the progress that has sulted from the legislation passed wake of the debacle, and to ap-aise its effects. My comments are ose of one who is now an ''outsider'' far as the state organization is con-rned, and represent my own opin-ns, based on material generously rnished me by the various officers ncerned.

The new laws may be grouped as follows:

(1) those respresenting transfer of non-accounting functions from the Auditor to other divisions;

(2) those directed toward increased fiscal controls and improvements in financial management;

(3) those involving more minor, though nevertheless significant, changes in procedure.

This article will limit itself to the first two, and will dwell primarily on the second, of the groups.

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[1] For a more complete review of this legislation, see the author's article in Winter 1957 *The Illinois Certified Public Accountant.*

[2] Following is a summary of the losses and sources of recovery:

Misapplication of funds of closed banks in Auditor's possession	$ 546,685
Restored prior to resignation	528,880
Balance unaccounted for	17,805
Amount of state warrants fraudulently drawn and cashed	1,024,679
Total claim of state	1,042,484
Recovery: from assets of offender turned over to State	547,484
from bond of Auditor (surety company)	50,000
from bank which cashed warrants and its insurer	425,000
Total	$1,042,484

There were also many other expenditures from which the State received little or no benefit. Some recovery of property received and diverted in this manner was made, but in most instances a valid claim could not be established. However, the State did recover the full amount of direct forgeries and misused funds as established by the independent audit.

Transfer of Non-Accounting Functions

First, the legislature took away from the Auditor the things that gave him control over property and money. Among these were the *supervision of the inventory of all state property,* real and personal, in use by the various departments and institutions. This the General Assembly transferred to the Department of Finance.

Next, and very important, was the *examination of banks and other financial agencies.* For this function, the General Assembly created a new Department of Financial Institutions, and this change was approved by the voters in a referendum as required by the Constitution. Full efficiency of the Department can only be realized as personnel is improved by the development of technically competent staffs to carry out examinations in all areas. This can reasonably be expected to follow. (More extensive use of CPA firms in these audits would be advantageous. This was recently suggested by the Director of the Department.)

Certain other minor non-accounting functions were also removed from the Auditor's office, leaving it charged only with duties relating to auditing, disbursing, accounting, and financial reporting. Other than the supervision of the municipal audit program, these relate entirely to the State's operations. It should be stated that all these activities are being well carried out at present.

Increased Fiscal Controls

One weakness leaving a loophole for mismanagement was the absence of required *procurement standards and contracting procedures* applicable to elective officers. Existing laws requiring competitive bidding and central purchasing did not apply to elected officials.

Laws enacted by the 1957 General Assembly require *all* officers and agencies to follow principles of competitive bidding in all procurement and contracting. A new division of Administratinve Services was established in the Department of Finance to administer these laws. No longer may any official, even though elected, incur obligations without proper competitive and contracting procedure.

These laws have been implemented and competent appointments have been made to administer them. According to the best information available, they are working well and are having the desired effect.

The major weaknesses which made it possible for an officer to disburse and realize state funds fraudulently over a three-year period before detection, however, were in the areas of state *fiscal controls.* These were corrected by three important pieces of legislation.

The first of these has to do with *budget procedure.* A unified all-state budget has long been provided for under which the Department of Finance is made responsible for assembling the budget, and the Governor for its presentation to the General Assembly with his recommendations. The General Assembly had established the Budgetary Commission of its own members, to review the requsts of agencies.

In spite of many good features, this procedure was deficient in that, among other things:

(a) review by the Budgetary Commission was inadequate because of lack of technical staff;

(b) there was little follow-up of

lepartmental spending by the Budgetiry Commission;

(c) the General Assembly was insufficiently informed about the budget.

In 1957 the General Assembly provided for an enlarged Commission and for a technical staff to assist and advise it. Implementation was delayed for two years because of lack of financial provision for its operation. This was corrected in the current biennial budget. Recently an experienced director has been appointed by the Commission. Improvement can be expected n time. There is no lack of good *executive* control of the budget after t is passed. The problem relates to getting a good budget enacted and keeping legislative contact with it.

A second condition of major importance was the *absence of any external financial control* over the Auditor's Office. This office was the only state agency not subject to some control of his kind. For departments and activities under the Governor, the Department of Finance maintained a strict continuous and even detailed supervision of expenditures. For these and all other offices and agencies, the Auditor made a kind of preaudit of every disbursement from state funds. While this by necessity was (and still s) in many respects perfunctory, it nevertheless was the principal point of reliance that the transaction was at least on its face regular and valid. As to his own office, he was in the position of making the only such examination of his own expenditures.

For the state as a whole there was in most instances a lack of a proper combination of responsibility and authority in officers and agencies charged with spending, with the requisites of good financial management and accountability often missing. There was undue reliance on central preaudits and accounts, thus weakening the sense of responsibility of spending agencies. There was a lack of a comprehensive or coordinated system of financial reporting.

Correction of these conditions was embodied in H.B. 602 (1957), the preamble to which states its objectives as follows:

"Place the financial management of the State on a sound basis;

"Place financial responsibility on State Agencies and hold them accountable for the proper discharge of this responsibility;

"Require professional, accurate and current accounting within the State agencies;

"Require proper utilization of State property;

"Decentralize fiscal, procedural and administrative operations to expedite the business of the State and to avoid expense, unwieldiness, inefficiency, and unnecessary duplication where decentralization is consistent with proper fiscal management."

To carry out these objectives, a Division of Accounting was established in the Department of Finance with power and duty to:

Establish principles and standards;

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Perform "procedural audits" of all state agencies;

Examine accounts of any agency receiving appropriations.

(The latter was not intended to be a financial audit, since this responsibility was given to the Auditor General.)

Improvements in Financial Management

With these provisions, the stage was set for development of a new concept of financial management in the State, placing authority where responsibility was fixed, placing records where they would be of service to management and could be kept current, combining accountability with authority.

The implementation of this law has proceeded with considerable vigor. The Division of Accounting was created, and Mr. C. F. Aiken, an accountant with extended experience in State accounting, placed in charge. A Bulletin was issued: *Requirements for Internal Control and Recordkeeping in State Agencies* (Dec. 27, 1957). Procedural audits were initiated. An excellent manual covering such audits was prepared for the guidance of field auditors: *Procedures Audit Manual*, (March, 1958). "Procedures Audits" is a relatively new term as such. The following excerpts from this Manual will aid in understanding what is contemplated by it:

"*Definition*

A procedure audit is an independent appraisal of financial management policies, methods and procedures. Such an appraisal will measure and evaluate the effectiveness of these policies, methods and procedures in providing adequate accountability for, and internal control over, the receipt, expenditure and residual balances of State assets."

"*Purpose*

The purpose of the procedures audit is to establish, by independent means, that each Agency of the State is using proper, efficient fiscal methods to provide adequate accountability and internal control, as measured by the financial management standards of the State as a whole.

"It is necessary to distinguish clearly procedures audit, 'post audit,' and 'internal audit.' In a typical business organization procedures audit does not exist, and is not required as a separate activity, because both post audit and internal audit involve a review of procedures from the standpoint of the organization as a whole. In the post audit the extent of this review and the manner of making it are normally directed at establishing the validity of the financial statements for the purpose of expressing an opinion on them to outsiders; in the internal audit the extent of the review and the manner of making it are normally directed at establishing the validity of the financial statements *and* compliance with assurance to the management of these areas.

"In contrast to a typical business organization, the State is composed of a large number of diverse and relatively independent Agencies, each of which is *separately* post audited under the direction of the Auditor General, and many of which have developed their own internal audit programs. The Department of Finance is charged with the responsibility for placing the financial management of the State, as a whole, on a consistent, sound basis. Procedure audit is one of the methods of doing this, since it provides a means of evaluating the financial management procedures employed by all State Agencies.

"In summary, post audit, internal audit and procedures audit all involve a review of Agency procedures. However, the specific procedures covered, the extent of the review, and the manner in which it is made are different because of the differences in purpose."

First attention was given to constitutional offices, previously exempt from anything of the kind. These have all been covered, along with some other departments. Substantial im-

provement in controls and procedures has resulted in a number of cases. There is good coordination between this Division and the Auditor General and the accounting firms making independent post audits. Internal financial reports have been placed an a current basis.

Consideration of recommendations proceeds cooperatively between the Division of Accounting and the departments concerned. This is, of course, the correct way to bring about effective and lasting improvements. The Procedures review of the Department of Finance was made by an outside public accounting firm.

One important subject which affects both budget-making and accounting is under active consideration: the *simplification of the elaborate system of object analysis of expenditures* now in use, and greater emphasis on functional and activity classification. If something substantial can be accomplished along this line, not only will the financial procedures of the departments and the state be aided, but information concerning the financial operations of the State will also be greatly improved.

One of the objectives of H.B. 602, the development of agency responsibility and autonomy, appears to be proceeding rather slowly. The extension of external financial controls to the Auditor's Office and other elective offices has been accomplished, but the basic goal of development of departmental responsibility is still some distance from realization. The Finance Department still maintains its central accounts of all executive departments, on an obligation (encumbrance) basis. In many instances they duplicate records maintained in departments. In some cases there are three sets of appropriation, expenditure and obligation accounts: one in the institution or branch, one in the central office of the department, and one in the Finance Department. In addition, appropriation accounts on a cash basis are maintained by the State Treasurer and the Auditor of Public Accounts. All of these duplicate each other more or less. The goals of H.B. 602 are recognized, however, by those in charge, and it can be reasonably expected that as time passes and agency competence increases, they can be realized to a greater degree. Competent accounting personnel in the larger agencies is an important key to such advancement.[3]

Independent Post Audits

In many ways the most important of the corrective actions taken, and in some respects the most critical condition calling for attention, was that of *independent post audits.* Also, this is the area in which the most has been accomplished.

The General Assembly had added to the constitutional duties of the elected Auditor of Public Accounts to *pre*-audit and handle the disbursements of all state funds, the responsibility for *post*-auditing the same transactions. This was not only contrary to the universally accepted principles of separation of functions of internal control and external review, but left the Auditor free of any independent audit except such as he might direct. He thus had exclusive supervision of his own financial operations, and supervision of the post audits of

[3] A review of State Auditing and Accounting based on the actions in Illinois, by Eric L. Kohler, one of the consultants in this legislation, appears in August, 1959 *Journal of Accountancy.* A considerable part of it is devoted to Mr. Kohler's ideas for more fully accomplishing the goals of agency responsibility in state operations.

those operations. (As a matter of fact, no such audits were made during practically the whole tenure of the officer involved in the scandal. Further, most of the audits of all agencies were made by one firm, one of the officers of which was employed as chief assistant in the Auditor's office, in which position he supervised the audits made by his own firm. It is hard to conceive a more flagrant violation of the principle of conflict of interest.)

Acting generally on the recommendation of the review report, the General Assembly took two related actions of prime importance:

(1) It established a *new post of Auditor General,* to be a Certified Public Accountant licensed to practice public accounting in Illinois, with adequate responsible experience in accounting and auditing. The original recommendation was for appointment by the General Assembly, but this was modified to provide appointment by the Governor with the approval of the Senate, the incumbent to serve six years and subject to removal only on constitutional grounds of malfeasance or neglect of duty. Although his reports were to go to the Governor, he was not to be administratively responsible to that officer and was to report directly to the General Assembly.

(2) It established a standing *Legislative Audit Commission,* consisting of members of both houses, to receive and review reports of the Auditor General, and take such action as might be indicated, and report to the General Assembly. This Commission has its own Executive Director, experienced in state fiscal operations. An *Advisory Board of Accountants* was created to assist the Auditor General and the Commission.

Every office and agency of the State—elective or appointive—was included in the coverage of this program, under which the Auditor General was to make or cause to be made post audits of every activity, in accordance with generally accepted principles for such audits. At first audits were required to be made annually for all but the smallest agencies, but this was later modified to require only biennial audits. However, audit engagements are made early in the biennium and work is carried on and progress reports made to the Auditor General during the period.

Hon. Frank H. Whitney of Springfield, CPA and member of the Illinois Society, was appointed by Governor Stratton to this post, from a list submitted by the Society. On January 28, 1959, he made his first report to the General Assembly, covering audits of 162 agencies most of which had been individually submitted to the Audit Commission. The audits were carried out by 52 accounting firms, and covered the period since any previous audit had been made and to June 30, 1958. The Auditor General's report was thus submitted only a little over six months after the close of the period involved. The report was prepared with the aid of a committee of practicing accountants.

The report not only gives condensed financial data, but includes comments on internal control and financial procedure, as well as general comments on further improvements needed in both departmental and general organization and methods. A copy of the report of each agency went to it as well as to the Governor and the Budgetary Commission. Each report contained appropriate financial statements, a standard certificate of audit,

reviews of internal controls, and recommendations for improvement where called for.[4] The recommendations have received attention by the agencies and the Audit Commission, and many corrective changes of procedure, both departmental and general, have been made. Among the important improvements made, it may be mentioned that warrants covering expenditures from Auditor of Public Accounts appropriations are mailed to payees by the State Treasurer, instead of being returned to the Auditor for delivery as they were prior to July, 1956; and warrants against State Treasurer appropriations are returned to the Auditor for mailing direct, the same as any other agency, instead of being retained and mailed by the Treasurer as before. The Audit Commission has been active and alert in pursuit of its responsibilities, and has brought about many other needed changes. It has instigated the recovery of considerable sums due the State but not yet turned over. In a single case, this amounted to a sizable proportion of the Commission's biennial appropriation.

Post Audit Standards and Objectives

In arranging for audits by accounting firms, the Auditor General issues a Memorandum for the Accountant, together with a statement of "Instructions to Independent Certified Public Accountants performing Audits of State Agencies."[5] While it is stated therein that the "audits are to be conducted in accordance with generally accepted standards of professional bodies of certified public accountants," and a summarization of the auditing standards of the American Institute is included, reference is made to "Standards and Objectives for Audit Review" as issued and published by the Illinois Audit Commission. These standards, as they now stand as first issued in January, 1958, and republished in the Third Annual Report of the Commission March 1, 1960, are at this time as follows:

ILLINOIS LEGISLATIVE
AUDIT COMMISSION

Standards and Objectives for Audit Review

1. Have expenditures been made and revenues received only in accordance with applicable laws and statutes and in accordance with the legislative appropriation and other state fiscal requirements and restrictions?
2. Have expenditures been made in compliance with State business practice requirements?
3. Are there adequate controls of, and regularity in, personnel and payrolls?
4. Is the agency collecting and accounting properly for all revenues and receipts and is the handling of money properly protected?
5. Are assets of the agency or in its custody, including money and property, adequately safeguarded and controlled and utilized in an efficient manner?
6. Are the financial records, financial reporting, budgetary controls adequate; are they maintained in accordance with accepted accounting principles and do they properly reflect an accurate picture of operations and financial conditions?
7. Do the financial records and reports reconcile with state fiscal offices and disclose all relevant facts?
8. Are internal checks and controls adequate?
9. Is there any evidence of fraud or dishonesty? Are there possibilities of such, and what changes are needed to deter or prevent their occurrence?

[4] A more detailed review of this program appears also in E. L. Kohler's article in August, 1959 *Journal of Accountancy*.

[5] This Statement has been reviewed in a paper by Waldo Mauritz "Mimimum Standards for Municipal Audits, "*The Illinois Certified Public Accountant*, Spring 1960, and the details set forth by him will not be repeated here.

10. Is the agency carrying out only those programs or activities authorized by the General Assembly?
11. Is the agency conducting authorized programs efficiently and in the manner authorized and what areas need improvement?
12. Has the Auditor certified without qualification or with a clear statement as to why not?

Some accountants have questioned the appropriateness of Item 9, relating to the detection of fraud or dishonesty. The profession is always concerned over the inclusion of any such reference, in view of its experiences in certain cases, and in view of the implications and possible liabilities of accountants if held responsible for detection of any or all fraud. Obviously, such an obligation cannot and should not be assumed or implied.

On the other hand, while the detection of fraud is not the main purpose of and only rarely a specific purpose of any audit, it would seem that in any audit an auditor, as one writer has said, "should be alert to indications of possible fraud in the conduct of his audit."[6] The Commission does not ask that the auditor say that "no fraud has existed." It does say, "Is there any evidence of fraud or dishonesty?" Perhaps the statement should be more explicit and say, "Did the audit disclose any evidence of fraud or dishonesty?" I do not see how any responsible auditor could be justified in ignoring the subject, and I believe no auditor does this. If so, I do not see how he could object to such an interpretation. In view of our Illinois history, so fresh in the minds of the Legislature and the public, it does seem an item of consequence which the Audit Commission could hardly forego, or that auditors can ask they disregard.[7]

The Post Audit Program and Independent CPA's

The post audit program, as headed up in the Auditor General and the Legislative Audit Commission, constitutes the area in which the accounting profession is brought closest to the state's operations. Its members have served well in this respect. A legal link is provided between the State and the profession through the Accountants Advisory Board. The work of this Board could be more fruitful, and will doubtless become so, as time progresses. There is no evidence of it having been called upon by either the Audit Commission or the Budgetary Commission as the law creating it indicates. On the other hand, committees and members of the Illinois Society and other accounting organizations have been helpful, as have individual firms and accountants. The result has been a close and mutually agreeable liaison between the Auditor General and the profession.

A highly important factor in this audit program, in addition to professional competence, is that of *independence* of the auditor. Since the General Assembly is the appropriating body, it should have an independent report as to whether the funds appropriated by it have been properly expended and all money and other property properly safeguarded and accounted for, and whether its actions have been followed. Complete independence of the Auditor General and

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[6] Charles A. Stewart, *Journal of Accountancy*, February, 1956.

[7] The State post-audit program, including a consideration of Standards and Objectives, was discussed at the annual meeting of the Illinois Society of Certified Public Accountants in June 1960.

those working with and under him, from any executive or administrative direction or influence, is of the highest importance. This would be most fully insured by having this officer appointed and responsible only to the General Assembly. The Legislative Audit Commission would offer a practical point at which this responsibility could be assumed. This is the procedure in California, where a generally similar set-up exists.

During the 1959 Legislative Session, a change was proposed which would have reduced the independence and the professional competence of this program. Under it the Department of Audits, headed by the Auditor General, would have become in effect, a "code department" and therefore more or less under the supervision of the Governor. This would violate a fundamental principle of independent auditing, since a major part of the financial operations being audited are in activities for which the Governor is responsible and over which he has supervision. To give him authority of any degree over the Auditor General would be contrary to good organizational principles and sound auditing procedure. The bill containing this provision did not pass, and such a change should not be permitted to happen.

Reporting Experience

Some complaints were made of the fact that the Auditor General included in his report to the General Assembly, a rather extended list of comments and criticisms on agency procedure. Certain officers and departments felt that these matters should have been handled directly with the departments and not be included in the general report.

It is true that in commercial audits, comments on internal procedures are often presented in separate letters to the management, and may not be included in the published reports. In the Illinois State situation, all reports are first discussed by the Auditor General with departments, and then submitted by him to the Audit Commission. Comments of departments are either submitted concurrently to the Commission, or discussions are held by the Commission with department representatives. In this way, agreement is usually reached as to the implementation of the auditor's recommendations.

It is the writer's belief that the Auditor General did a wise thing in reporting in such detail in his first report, so that the General Assembly might be fully informed as to the way in which the program established by it was being carried out. This had a beneficial effect, in spite of some irritation to departments. In the future, it may not be necessary to include so much detail. All reports of accounting firms and of the Auditor General to the Commission and the General Assembly are matters of public record, and departments have every opportunity to defend themselves if they feel any injustice has been done.

Effectiveness of Post Audits

Operation of the post audit phase of the fiscal reorganization plan approved in 1957 indicates clearly that (a) the program is sound and workable, (b) that it has had competent and intensive attention in its implementation, and (c) that it is an important link in preventing mishandling of funds as well as aiding improved financial management in the entire State organization.

Having an opportunity to observe different methods followed in other states, where state post-audit officials have tried to handle such audits (and frequently audits of local government units as well) by their own staffs, I have no hesitancy in saying that the Illinois system of having the audits made by outside certified public accountants, is better, and I hope it will be permanent. In addition to the difficulty of maintaining a competent force, there are problems of delays, excessive attention to details, varying standards, which have been conspicuously absent in Illinois.

In summary, experience with the Illinois fiscal reform program established in 1957, has clearly indicated:

(1) that it is well conceived;

(2) that it has been well organized and is progressing impressively;

(3) that it adequately provides the mechanics for prevention or early detection of the kind of mismanagement which happened in 1956 should that ever be attempted again.

In addition, there are these further benefits and advantages:

(1) there has been a proper separation of functions between internal controls and independent review, between agency responsibility and central administrative supervision, and between legislative and executive responsibilities;

(2) the General Assemply has been made increasingly aware of the problems of financial control and is exercising its responsibility for them more fully;

(3) significant improvents in management have been brought about in the various departments;

(4) the accounting profession in Illinois for the first time has been brought into close contact with the operations of the State government and given an opportunity to apply its professional abilities to them in an effective manner.

Future Goals in Fiscal Improvements

Is anything further needed to be done to improve fiscal procedure in the Illinois State government?

(1) As to fiscal controls: No further changes appear necessary. All essential checks are provided for, and there is an adequate separation of responsibility. The new organization has proved its effectiveness. The essential needs for the future are (a) to maintain the independence of the Auditor General from encroachment or control by the executive branch; (b) to increase respect for the Audit Commission; and (c) to increase departmental initiative and sense of fiscal responsibility.

(2) As to accounting and financial reporting: There is substantial and costly duplication as well as incompleteness. Two or more offices in numerous instances are keeping records which largely or completely duplicate one another and provide no additional safeguards. Excessive and unnecessary duplication and detail appear in financial reports issued by various officials. No single report covers all the State's finances.

(3) As to fiscal organization: There is overlapping and duplication among independent fiscal offices, and in some cases the method of selection is not such as to insure professional competence. Political election is an unreliable way to select an auditor, for example. Sometimes a good one

s secured in that manner, but there can be no certainty that will be the result. The standards set for and the experience in filling the new post of Auditor General in a competent manner are in sharp contrast to the methods of choosing elected fiscal officers.

(4) As to operating personnel: Any business operation is only as good as the people in it. Elective offices continue to be exempt from the provisions of the state personnel system of merit and tenure. This system should be extended to all offices and agencies and cover all but policy personnel. Only in this way can a career service be established which will attract the needed competence for the State's business.

To enable any business to progress accounting-wise, and to put accounting at its proper level as a partner in management, there must be an increased and steady input of persons qualified educationally and personally to perform essential duties, assume responsibility at various levels, and capable of advancing into high echelons. In government especially there is a substantial shortage in such personnel at this time. Don't expect the gigantic federal government or any state or major local government to perform a miracle in revolutionizing its accounting, irrespective of laws, commissions, and expressions of intent. Don't expect it to perform at all unless it can get the competent man-power to do the job right.

Accounting and other finance and business operations of government offer many attractive inducements to business graduates. These are growing more favorable all the time and many are well worthy of consideration. To be acceptable and win success in them, persons who follow this lead must have acquired a knowledge of the conditions and techniques found in public operations. The accounting profession and our schools of business have both a responsibility and a challenge for helping bring this to pass, and enlisting the interest of competent personnel in such opportunities.

ACCOUNTANCY AND ECONOMICS

Accountancy and economics have the same objectives of cognition. Both branches examine the individual economic cell as well as the entire economic body of a country. In the center of these studies are the administration of scarce resources and the determination of income and production income.

Richard Mattessich, "The Constellation of Accountancy and Economics," *The Accounting Review,* October 1956

A forceful case for inclusion of equipment lease obligations in dollar amounts in the balance sheet

Equipment Leasing and Generally Accepted Accounting Principles

By Robert W. Baltz

Before getting into the subject of equipment leasing and generally accepted accounting principles a few ground rules should be established in order to keep the discussion within reasonable limitations.

First, these remarks center on two points: (a) on leasing only as it applies to equipment and then only to those cases where there is not only a lessee and a lessor, but also a third party financing the lease, and (b) on certain accounting implications arising from that kind of leasing. The discussion to follow rests upon this exclusion basis, and as you follow the discussion, please don't be saying to yourself, as most people want to do when this subject is mentioned and before there is even any discussion, "Yes, but what about long term leases on real estate, what about executive deferred compensation programs, etc." It is perfectly fair to talk about equipment leasing by itself; it is a subject which can stand on its own feet. You might place yourself in your professional position as a CPA talking to your client who says to you, "Now look, I don't have any long term real estate leases, I don't have any deferred compensation programs, but I do have equipment leases, and that's what affects me and that's what I want to talk about."

Second, these remarks are directed primarily to certified public accountants and pertain to what such accountants refer to as "generally accepted accounting principles." This is not a discussion of the subject of leasing versus ownership. Third, only the liability side of the accounting question will be discussed, excluding, however, the question of whether the liability should be shown at face amount or on a discounted basis. And fourth, the tax question, while very important, is not pertinent to the point of these remarks and therefore will not be discussed.

One more preliminary comment may be necessary for the reader to achieve the proper perspective for this discussion. I believe that amounts representing such a lease of equipment

should be disclosed in dollar amounts in the body of the balance sheet of the lessee, rather than disclosed on the basis of a footnote and then only if material in the circumstances.

Chapter 14, Accounting Research Bulletin #43

Chapter 14, Disclosure of Long-Term Leases in Financial Statements of Lessees, of Accounting Research Bulletin #43, contains the following statements, which, while taken out of context, are particularly pertinent to the problem under consideration:

(1) "Three years has been used as a criterion in some cases for classifying leases as short term or long term."

(2) ". . . where the rentals or other obligations under long-term leases are material in the circumstances, the committee is of the opinion that disclosure should be made in financial statements or in notes thereto . . . ," and

(3) "Since the lessee in such cases does not have legal title to the property and does not necessarily assume any direct mortgage obligation, it has been argued that any balance sheet which included the property among the assets and any related indebtedness among the liabilities would be incorrect. However, the committee is of the opinion that the facts relating to all such leases should be carefully considered and that, where it is clearly evident that the transaction involved is in substance a purchase, the 'leased' property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement."

It is my understanding that at the time the committee was giving consideration to Chapter 14, the only leases of major importance which then were raising questions in the minds of the CPAs were those relating to real estate, and accordingly the members of the committee felt they were issuing a bulletin which dealt only with real estate. I have, however, heard the opinion that the principles which were stated are sufficiently broad so that they may just as appropriately be applied to material long-term leases of other types of assets, and that the reasoning set forth in the Chapter would lead to the same conclusion if applied to long-term leases of long-lived equipment. So much for Chapter 14.

How Equipment May Be Acquired

Let us now consider a simple example. Assume that a given company is going to acquire the use of a machine costing \$500,000. There are several ways that can be done:

(1) by paying cash,

(2) by arranging a bank term loan,

(3) by employing a conditional sale contract, or

(4) by signing a chattel mortgage.

Let us assume that each one of those *three forms of debt* is payable in the same way, namely, in five equal annual installments of \$100,000 each.

As to the accounting treatment with respect to each one of those *four methods*, a CPA would require absolutely that:

(1) the transaction be recorded on the books,

(2) fixed assets be debited and, as the case may be, cash or liabilities credited, and

(3) the amounts representing the transaction be included as dollar amounts in the body of the balance sheet in fixed assets and, if not a cash transaction, in the apropriate liability caption classified either as current or noncurrent.

I would like to see the reaction of a CPA if a client tried to argue that any one of these transactions need *not* be recorded on the books, and that the amounts *not* be included in the body of the balance sheet, but at

the most, merely be shown as a footnote to the balance sheet and then only if material in the circumstances.

This example reminds me of what Sherlock Holmes would say to Dr. Watson, "Purely elementary, purely elementary."

Let us now talk about another way in which the company can acquire the use of this same $500,000 machine, and that is via the equipment lease.

The Equipment Lease

While most accountants are familiar with the usual mechanics of this kind of a leasing arrangement, a brief summary may be in order at this point, applying the mechanics to the preceding example. For purposes of simplicity we will use the $500,000 figure flat and overlook carrying charges, prepayments of rental of the final two or three months, etc. The lessor buys, according to the specifications of the lessee, and takes and retains title to, the machine. The lessor enters into a non-cancellable lease with the lessee, "carefree" to the lessor, and wherein the lessee agrees absolutely and without reservation to pay the rental of $100,000 a year for five years. The lessor borrows from a bank the $500,000 it needs to pay the seller of the machine. The lessor gives its note to the bank, payable $100,000 annually for five years, and secures its note by giving the bank a chattel mortgage on the lessor's interest in the machine. But most importantly to the bank, the lessor assigns to the bank the lease payments which are to be made by the lessee. The lessee is put on notice of such assignment, and agrees to make all the lease payments directly to the bank, and frequently agrees not to assert against the bank any defense or claim which the lessee may at any time have against the lessor. Under an agreement with the lessor, the bank applies the lease payments it receives from the lessee to the payments due by the lessor on its note to the bank. When the lessor's note to the bank is paid the bank releases both the assignment and the chattel mortgage and the lessor then owns the equipment free and clear.

The Lease as a Use of Credit

Assume now that you are the lending officer at the bank which is financing this equipment lease. As the lending officer you view this request for equipment lease financing as a *request for credit*. Although the underlying document, the lease, is different in legal form from a bank term loan, a conditional sale contract, or a chattel mortgage note, the request for the financing of this lease is nevertheless a request for credit *and the credit is that of the lessee*. Although your bank holds the note of the lessor and does not hold any notes of the lessee, you look for payment to the ability of the lessee to make the lease payments to the bank pursuant to the assignment.

A few years ago a representative of a leasing company approached one of our then top Vice Presidents, a seasoned and widely recognized bank credit man, with the proposition that we finance a several hundred thousand

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ollar equipment lease for a lessee who as one of our fine customers, and to hom we had extended a plain note edit line of several million dollars. ur Vice President talked to the reasurer of the proposed lessee say-g that we would be glad to finance e proposed lease if the Treasurer ished us to do so, but if we did, we ould consider the amount of that ase financing as a use, to that ex-nt, of the line of credit we were xtending to the company. The cap-ble and experienced Treasurer of hat nationally known firm replied hat he, too, would consider any such ase financing by us as a use to that xtent of his line of credit.

Donald R. Gant, of the investment anking firm of Goldman, Sachs & o., in his elaborate article, "Illusion n Lease Financing," in the March-pril 1959 *Harvard Business Review* rote: "Like all types of borrowing, ease obligations draw on the credit f the borrower, and credit is not a ottomless well. If it is used in one orm, it is not available to be used gain in another," and, further, . . . there are dangers in the growing rend toward lease financing to the xtent that companies using it, and nvestors in their securities, fail to ppreciate the implications of their ounting lease commitments merely ecause they are buried in a footnote ather than appearing as liabilities n the balance sheet."

If you are willing to finance a cer-ain obligor, and if you are willing to nance our subject machine for him, ou will not particularly care whether e financing is via a bank term loan greement, a conditional sale con-ract, a chattel mortgage note, or an quipment lease. If the obligor has e ability to pay, he can satisfactorily pay out any one of those forms of debt; *if he does not have the ability to pay, it won't make any difference whether the obligation is under a lease.* To repeat, because this is so important, *it is the* credit of the lessee —it is not the credit of the lessor. What else can the lease obligation of the lessee be other than debt? And as such it should be shown in dollar amounts in the body of the balance sheet of the lessee.

The Lease and Financial Management

Now assume that you are the Financial Vice President of the company which has acquired the use of our $500,000 machine under the five-year lease, payable $100,000 annually. In that capacity one of your responsibilities is to see that the company's financial obligations are paid as they become due and payable. You operate intelligently and maintain running forecasts of the total debts that will be coming due. That total includes all the various debts of your company such as trade payables, payrolls, taxes, debentures, dividends, payments under a bank term loan agreement, payments under conditional sales contracts, payments under chattel mortgage notes, as well as the lease payments for the machine. Obviously, to make those payments, lease and others, you have to have funds.

At this point a few questions are in order. When a businessman is straining every muscle to gather together the necessary funds with which to pay his bills, when he is prodding his collection department to get some accounts collected so he can get his dollars together, when he is getting after his purchasing department to

keep purchases at a minimum so that he will not be building up a bigger amount of bills to pay, when he is urging his production and scheduling department to keep things rolling so that he can keep his inventory down to a minimum, when he is trying to hold down expenditures of all kinds and doing everything he can to get the dollars together to pay his bills, is it any easier for him to raise the dollars to pay his lease payments than it is for him to raise the dollars to pay all his other bills? Of course it isn't any easier. The dollars he needs to make the lease payments are just as hard to come by as are all the other dollars he needs to pay his other bills. Why should the lease debt be treated any differently on the balance sheet?

For some strange reason the equipment lease contains a lot of accounting magic. Under the lease in the preceding example exactly the same machine was involved, for exactly the same $500,000, and payable in exactly the same schedule of $100,000 annually for five years as was involved under the previously mentioned other methods by which the use of this machine could be acquired. One might say, "Ah, but under the lease the company does not have title to the equipment"—and I would agree. But I would also say, regardless of whether the company has title, it has, under the lease, incurred a financial obligation, a debt, as direct, as real, as financially burdensome, as inescapable, as under the bank term loan, conditional sale contract, or chattel mortgage note.

As a matter of fact, a lease obligation may be even more inescapable than an obligation under those other forms of indebtedness. If a businessman has title, or even conditional title, to a piece of equipment, he has some control over the equipment and is in a position to dispose of that equipment if he so desires, with, of course, a simultaneous payment of any obligation against it. Under a lease arrangement, however, because he does not have title, even conditional title, he is not in any position to dispose of the equipment and hence relieve himself of the lease obligation. To relieve himself of a lease obligation the businessman either has to pay the remaining amount due under the lease or obtain the release of both the lessor and the institution financing the lease, and I should imagine that would not be easy. Consequently, the lease obligation is perhaps an even tighter financial obligation than the obligation under any one of the other forms of financing that have been mentioned; yet the lease obligation continues to receive magic accounting treatment.

Quoting Donald Gant again: "... the lease creates a commitment on the part of the company to make a series of payments over a future period of time, which is as much a fixed obligation as the interest and sinking fund requirements of a debenture issue.", and, further, "It (the lease) is seen as basically another form of debt financing."

Reporting the Lease Obligation

Whether it be a bank term loan agreement, conditional sale contract, chattel mortgage note, or equipment lease, in essence each boils down to the same four words "I promise to pay." What else is that but a liability which should be shown in dollar amounts in the body of the balance sheet of the obligor?

An article by Kenneth R. Rickey,

Including All Leases in the Balance heet—a First,'' appears in the De-ember 1959 *NAA Bulletin.* The uthor is a CPA and at the time of is article was the Vice President nd Treasurer of Lenkurt Electric o., Inc., San Carlos, California. The enkurt Company previously used the ootnote basis of disclosing informa-ion relating to leases, but the foot-ote basis, to qquote Mr. Rickey '' . . . eemed wholly inadequate for anyone nalyzing our financial position.''

In speaking, however, of his ecember 31, 1958, balance sheet, Ir. Rickey said ''Lenkurt Electric chieved a *first* by reflecting in the alance sheet *all* its leased facilities nd related long term lease obliga-ons.'' My congratulations to Mr. ickey and Lenkurt Electric.

The position of Lenkurt Electric n showing their lease figures in the ody of the balance sheet is a new wist—just the reverse has been the ustomary practice, namely, to keep he lease obligations out of the liabili-es on the balance sheet. The latter ractice is referred to as ''cleaning p'' the balance sheet. I suppose on hat theory you would call Mr. ickey's balance sheet ''dirtied up.''

Here are several more quotes from r. Rickey:

> (1) ''We believe that to continue with just the footnotes would be to omit significant plant assets, productive facilities and fixed obligations from the balance sheet.
>
> (2) ''Leases of the nature under discussion here are in most respects undistinguishable from mortgages or other debt instruments.
>
> (3) ''In the case of companies with loan agreements prohibiting additional debt or prohibiting the pledging of property to other lenders, leasing arrangements have been adopted because such contracts appeared to be outside of the restrictive loan covenants and because accounting practices did not require the obligation to be shown in the balance sheet.''

With respect to that last quotation, the term lenders during the past several years have closed their loophole by including, as standard equipment in their loan agreements, a covenant restricting lease obligations. But the accountant's loophole of *not* requiring the lease liability of the lessee to be shown in dollar amounts in the body of the balance sheet of the lessee remains wide open.

And a final quote from Mr. Rickey:

> ''Such presentation'' (of reflecting in the balance sheet *all* its leased facilities and related long term lease obligations) ''is not in conflict with generally accepted accounting principles nor with pronouncements of the American Institute of CPAs and the SEC.''

It was brought to my attention, however, that subsequently the SEC required Lenkurt Electric to remove the lease figures from its balance sheet totals although permitting the title captions to remain in the body of the balance sheet, with the figures extended short, and that that action was taken on the basis that to include the lease figures in the totals was not in accordance with generally accepted accounting principles.

I have asked the SEC to inform me what position they took in this case but the SEC has replied that it would be inappropriate for them to discuss any consideration given to the content of the (Lenkurt) registration statement (presumably because the registration statement was withdrawn). Consequently, having no official statement, I am unable to comment. But, if the information in the preceding paragraph is factual, then may I say: I agree there is a de-

ficiency, but in my opinion, the deficiency is not with Lenkurt Electric —it is with this thing called "generally accepted accounting principles."

The February 1960 Bulletin of the Robert Morris Associates, a national association of bank credit men, carries a speech: "Capitalization—Debt and Equity" by Fred C. Witte, Vice President of The Chase Manhattan Bank. In the section, "Full Disclosure of Liabilities: Lease Obligations" Mr. Witte said:

> "Bankers and financial institutions in general are leaning more and more to the view that obligations like leases are as important a debt as notes or bonds and should be shown." "As a going concern . . the lease can be likened to debt since it requires fixed payments which must be met regularly," and "Thus far, the accounting profession has failed to establish rigid provisions for disclosure of lease obligations."

Reporting of Leases: Hope for the Future

In the February 1960 *Journal of Accountancy*, Mr. Weldon Powell, the Chairman of the recently created American Institute's Accounting Principles Board, has written a most interesting article "The Challenge of Research." Two statements in that article are: "The Institute can and it should take definite steps to lead in the thinking of unsettled and controversial issues," and "At the same time I do not think that the profession has done enough to promote sound accounting through persuasive effort." I am glad to see the Chairman of this important committee take that progressive position. Accounting Research Bulletins are very valuable and needed contributions to accounting. The American Institute of Certified Public Accountants is a great professional organization and its pronouncements do, and should, bear very considerable weight.

At another place in the article, Mr. Powell writes: "We appear to regard form more highly than substance." May I say that equipment leasing and present generally accepted accounting principles are a perfect example of where *we are slaves to form and completely overlook the substance.* Right there is an excellent opportunity for the Accounting Principles Board to do what its Chairman has suggested: take a "definite step to lead in thinking" and to "promote sound accounting."

I am heartened by the creation of this new Board, by Mr. Powell's article, by the article in the December 1959 *Journal of Accountancy*, "Challenges to the Accounting Profession in the United States," in which article Mr. Carman G. Blough lists 18 specific areas of accounting principles which seem worthy of consideration and of which item #7 relates to leasing, and by the announcement in the February 1960 "CPA—The Certified Public Accountant," that the first projects in the new expanded program of accounting research have been selected and that one of those six subjects is long-term leases.

The members of the Accounting Principles Board have a big task ahead of them and while I do not wish to add to their burden, I do hope they will be able, before too long, to remedy a long over-due situation by issuing an Accounting Research Bulletin which will *require* that the obligation under an equipment lease shall be shown in the figures in the body of the balance sheet of the lessee.

A look at some of the avenues of deferred compensation available for key personnel

Deferred Compensation— Where, When, and For Whom

By Arthur H. West

I am sure you are aware, upon ppy reflection, of the increase which s occurred in the last 15 or 20 years the scope of the accountant's funcon in his relation to his business ents. As actuaries and employeenefit consultants, we have come to alize through the changes which ve occurred in the three-way relanship in which we participate of tuary, accountant and mutual ent, that many certified public acuntants render valuable services in e area of what might be defined as Management Consulting." Thus, st accountants are acquainted with st of the areas upon which this esentation will touch.

The presentation will begin with a view of pensions plans, sail blithely ough profit-sharing, stock bonus, m life insurance, thrift and stocktion plans, and conclude with comnts as to individual employee dered compensation contracts. As s course is being followed, it is ended to emphasize matters relating to key personnel. Further, it is intended to dwell not upon detail but largely upon the thoughts which have been uppermost in our minds and in the minds of our clients when the question has been one of broad policy affecting the choice of form of deferred compensation.

In this presentation, the term "Treasury qualified" is frequently used. This is intended to identify a plan of deferred compensation which meets the requirements of Section 401 of the Internal Revenue Code of 1954. Plans which meet the requirements of this Section have certain abnormal tax characteristics. The basic abnormality is the ability of the employer to reduce his gross income in determining his taxable net income by the amount of his current contribution to a plan so qualified, although the increase in the employee's interest in such plan resulting from such contribution, is not then taxed and may not be taxed until some distant date.

Before undertaking the specific re-

view of each form of deferred compensation, a proposition of possible general application to the problem of deferred compensation for key executives will be considered. It would seem desirable to provide as much as possible of the total deferred compensation intended to be made available to key executives through the medium of Treasury qualified plans.

This proposition, which if adopted would constitute one of the objectives in seeking a solution to the problem of deferred compensation for key personnel, is made because (a) the tax status of the employee's interest under a Treasury qualified plan is comparatively certain and comparatively predictable; (b) the key executive is afforded a degree of security by virtue of the segregated funds maintained in either a trust fund or under an insurance contract, with respect to what is otherwise a bare and not always contractual promise to perform as to that portion of his total deferred compensation which is to be provided under Treasury qualified plans; and (c) as indicated in the discussion of the term "Treasury qualified," the employer can budget in advance the payments he will eventually make under the deferred compensation program to the extent it is part of a Treasury qualified plan. To the extent he can so do, the employer reduces the amount of his deferred and uncertain tax deduction which is of necessity at the other end of most all other forms of deferred compensation. Nothing presented in this argument is intended to convey the idea that Treasury qualified plans alone can meet the total needs of the key employee.

In order to carry out the proposed objective, it will be necessary to review carefully each existing Treasury qualified plan of the key executive's employer to see what changes might be made so as to give him a larger interest therein. It does not necessarily follow that any acceptable change in an existing Treasury qualified plan must be such as to affect alike both the key executive and all other employees. To illustrate, it should be determined whether or not the key executive's compensation base under each qualified plan pertaining to him may be enlarged so as to include therein part or all of any cash bonus or direct incentive compensation such employee receives. Ordinarily, the larger the compensation base, the larger the participating interest.

This presentation intentionally offers no detailed consideration of the problems that might arise under Section 162 of the Code which in effect requires that salary expenses, in order to be deductible, must be "ordinary and necessary" and further, be "reasonable."

Pension Plans

Pension plans remain the mo[st] efficient, economical and equitab[le] way of providing deferred compens[a]tion or retirement income for all em[-] ployees whether they be hourly pro[-] duction, salaried clerical, administ[ra]tive or "key" personnel.

To the extent an employer accep[ts] the cost of providing retirement i[n]come as a cost of doing busine[ss], that is, a cost which must be m[et] before profits are determined, th[e] profit-sharing plan is a poor substitu[te] for a funded pension program.

This is not a criticism of the pro[fit-] sharing concept as such. This is [a] suggestion that the Treasury qua[lified]

ed profit-sharing plan is a poor ve-
cle by which to discharge the obli-
ation to provide employees with an
lequate and equitable retirement
come. No matter how the formula
r allocating the employer's annual
rofit-sharing contribution among
articipating employees is writen, 80
90% of each annual contribution
ill be allocated, at least under a
reasury qualified plan in proportion
compensation; thus, the youngest
articipating employee and the oldest
articipating employee will be cred-
ed, if each has the same level of pay,
ith essentially the same dollar
nount. Equal amounts of monthly
e pension payable commencing at
e 65 cannot, of course, be provided
application of the same number of
llars if in one case the application
made at age 64, and in the other,
plication is made at age 35.

The proper choice of funding
edium in support of a pension
an affords the employer all of the
eedom as to the size of his contri-
tions for any given year of opera-
on, as is consistent with his accept-
ice of an obligation to set aside,
er a period of years, the sums
cessary to provide the promised re-
ement income.

This flexibility of contributions
ll most likely range for a "middle
the road" pension plan from 6%
15% of covered payroll in the
ry early years of operation. As-
ming a reasonable level of contri-
tions in such early years, the range
acceptable contribution for *any
ngle subsequent year* will be from 0% to 15% of covered payroll, assuming that such subsequent years average out at a contribution rate of, say, 6% or 7% of payroll.

Compliance with Treasury anti-discrimination rules is generally measured, in the case of a pension plan, in terms of the benefits generated by the plan's formula rather than, as in the case of the profit-sharing plan, in terms of how the company's annual contribution is allocated among participating employees. Thus, amending a pension plan in order to benefit a key executive can be fully effective, both as to past and future service, regardless of the age of the employee at the time of amendment. Amending a profit-sharing plan to benefit a key executive can only increase the magnitude of his future participation. There can be a terrific dollar difference in the amount of deferred compensation created as the result of the amendment of a pension plan as compared to that resulting from the amendment of a profit-sharing plan.

There has been a recent development in pension plans of interest to highly-compensated employees. Currently, for such employees, the so-called "normal retirement age" is effectively being lowered below the historically accepted standard age of 65. This is a trend running counter to the prediction often heard in the last decade that the normal retirement age would at some date in the future be raised above age 65.

In the case of hourly-compensated production employees who initiated

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this trend through union contract, retirement before age 65 without reduction of the accrued benefit has been largely limited to those employees who, while not totally disabled, are unable to perform the jobs which are available to them by virtue of their seniority. The combination of rules prohibiting compulsory retirement prior to 68 or later and permissible retirement at or after age 60 without reduction in the accrued benefit appears to be resulting in an effective average retirement age for such employees of somewhere between age 65 and 66.

On the other hand, this policy of permitting or requiring retirement prior to age 65 without reduction of the accrued benefit has moved into the front office to such a substantial extent that in some companies, it is reducing the effective average age of retirement for the salaried employee group as a whole to as low as age 62.

The reduction of the average age of retirement to as low as age 62 without reducing the amount of pension then payable below that then accrued, can increase pension costs between 20 and 25% and perhaps even more if a substitute is provided under the employer's plan for the then unavailable Social Security age benefits. This may be an important trend for at least some key executives. Apparently in the highly competitive consumer goods industries, it is sometimes deemed desirable to give a key executive a top assignment at age 55 with the prospect that he will hold such assignment for perhaps 5 or 6 years. At the end of this period perhaps neither the employer nor the employee will be satisfied to have the employee fulfilling a lesser assignment. These "earlier than age 65" special retirement benefits" are often used to cover this situation.

Some discretion must, of course, be exercised in the administration of this type of benefit since some employees will be permitted to retire early without benefit reduction while others will not be permitted to do so. The recently revised plans of the principal employers in the basic steel industry will shortly place before the U. S. Treasury the question as to what constitutes acceptable administrative standards, particularly with respect to the application of such plans to salaried employees. Currently, as you know, the Treasury tends to look for plans disqualifying selections in this area.

These "earlier than age 65 specia benefits" are in my opinion a fairl recent trend, at least in terms of th rather marked emphasis now bein placed thereon. However, a recen *New Yorker* magazine carried Whitney Darrow, Jr. cartoon show ing three "within the hour colleg graduates"—they wear gown an mortar board and have sheepskin i hand. One of the graduates says t the group, "I admit that Consol dated Aluminum has an attractiv starting salary and good fringe ben fits, but Allied Instrument offers a that *plus* optional early retirement.

Key employees obtained by hirin a proven executive from another en ployer often present a difficult pe sion problem. Usually the acquirin employer's pension program is geare to provide adequate benefits for th employees who will ultimately com plete 25 or 30 years of service. the key employee is hired at or ne age 50, you are, at least in his opinio immediately in trouble. However,

often possible to create a short-rvice minimum pension such that e increase in pension cost result-g from its adoption will be largely nited to that attributable to the in-ease in benefit for the employee in estion. It must, however, be borne mind that while such provisions ed not materially lift the level of nefits for the employer's long-rvice employees, whether high or v paid, nor necessarily lift the vel of benefits for the lesser paid, ort-service employees, they auto-tically and usually substantially crease pension costs as successive ort-service key executives are hired.

Some employers using a short-rvice minimum pension provision quire that the amount of prospec-e increase in pension cost be as-rtained at the time each hiring is ng considered, and that such cost a factor in the decision as to ether or not to hire the executive question.

ofit-Sharing Plans

In terms of Treasury qualified ns, profit-sharing plans have ad-ntages in the following situations:

(1) In each instance in which the mployer truly believes in sharing his rofits with his employees, regardless of whether he so believes as a matter of rinciple or because he feels the incen-ive afforded employees results in lower osts and overall greater profits.

(2) When established as a supplement o a pension plan because

(a) the employer, so doing, believes that the pension obligation has, in terms of a cost of doing business, a limit and that deferred income in excess of the amount to be provided as a matter of obligation should be dependent upon profits; or

(b) the employer, so doing, believes a retiring employee should have at retirement both a capital sum and a life pension. This is a generally accepted rule in many European countries, England and the British Dominions where many big-company employees have, for years, been engaged in foreign service and have, on retirement, a re-location problem.

(c) In personal service corporations wherein most of the employees are also stockholders. In these cases, the deferred compensation created is largely a redistribution and reclassification of capital accumulated or to be accumulated. If only reclassification is involved, then that which "A" loses as a stockholder, "A" will gain as an employee. If redistribution is involved, then perhaps what "A" loses as a stockholder, "B," also a stockholder, will gain in his alternate capacity of an employee. Generally, this method of converting otherwise immediately taxable income into deferred compensation is acceptable to the principals concerned only if the redistribution of capital is kept at a minimum and the reclassification thereof is maintained at a maximum. This test of acceptability is more easily met under a profit-sharing plan where, as compared to a pension plan, the attained age of employees and their relative periods of past-service are largely ignored.

This last example is illustrative of the time and place to consider seriously the requirements of Section 162 of the Code. This is a warning which it would seem would be of extreme importance if the corporate entity is to be taxed under Subchapter S (small business organizations) of the Internal Revenue Code.

Key employees can be favored to some extent under a profit-sharing plan by integrating the plan with Social Security, that is, by allocating a greater portion of the company's contribution with respect to that portion of each employee's annual earnings as are in excess of $4,800, than are allocated with respect to each employee's first $4,800 of annual earnings. Remember, however, that the Treasury rules permit only one integrated Treasury qualified plan to a customer. That is, either the employer's pension plan or his profit-sharing plan may be so integrated but not both. Further, this is not an easy course of action if you propose to do it by amending an existing plan which now allocates the company's contribution by some other rule. Under such circumstances, you are merely changing the basis of allocation of what is essentially a predetermined amount, and as a result, are reducing the interest of some participating employee in favor of increasing the interest of others.

Stock Bonus Plans

Treasury qualified stock bonus plans are, so far as can be determined, essentially equivalent to Treasury qualified profit-sharing plans. The differentiating element is the use of company stock either by the direct contribution thereof under the plan, or by the plan specifying that the trust fund's assets are to consist principally of stock of the employer. These plans have not received the same attention and use as have the standard profit-sharing plans.

Thrift Plans

The so-called thrift plan is the fourth and last form of deferred compensation which can be classified as Treasury qualified. Technically, it is usually qualified as a profit-sharing plan; however, it is not normally presented to employees as such.

Assuming that you can economically justify the establishment of such a plan for a group which will meet the Treasury's coverage requirements, such a plan can be written so as to be of major assistance in providing deferred compensation for key executives in a favorable form.

The typical thrift plan offers the participating employee continuing employer contributions to be credited to his account with the amount thereof equal to a percentage of his continuing contributions under the plan—most typically the employer's contribution is 50 cents for each dollar of employee contribution. In the usual case, the thrift plan is a profit-sharing plan only to the extent that employer contributions for any year cannot exceed the sum of current profits and previously accumulated profits, that is, earned surplus.

The amount accumulated for each employee is either (a) invested in accordance with the plan's stated formula, part in company stock and part in bonds, or (b) invested by employee direction in one or more of the investment programs made available under the plan. In the latter case, the three most common investment programs are (1) a general equity fund, (2) an employer stock fund and (3) an all bond fund. Generally, these plans permit an employee to vary his rate of contribution from 2% to 6% of his covered direct compensation.

Such a plan can be made more attractive to the key executive by the following procedures:

(1) Permit employees to withdr

eir contributions after stated minium periods of participation without ch withdrawal adversely affecting eir right to participate in the plan the future, or their right to retain their accounts, employer contributions previously credited thereto. A ry common arrangement is to pert withdrawal of the first year's ployee contributions at the end of e fifth year, the second year's emoyee contributions at the end of the th year, and so on.

The key executive who must receive o or more dollars before income xes in order that he may make a e-dollar after-tax contribution will preciate being able to participate der such a plan for 20 or 30 years ile limiting his contribution to, y, the aggregate of 6% of his vered pay for five years. You may k why five years? Why not two ars? The answer is that aside from atever opinion the employer might ve as to the appropriate holding riod under a plan designed to prote employee thrift, the minimum riod is normally governed by the an's vesting terms. That is, if an ployee can terminate his employent after two years of participating such a plan without forfeiting his terest in the employer's prior conibutions, then a two year withawal rule would not be illogical.

(2) If your key executives are, on e whole, your longer-service emoyees, you may be able to increase e permitted rate of employee conibution and thereby increase the te of employer contribution for ch employees by permitting all emoyees with 15 or more years of rvice, for example, to contribute much as 8 or 10% of their direct mpensation. Obviously, if you push this approach beyond a certain point, you will meet resistance from the Treasury Department based on the argument that a plan with such privileges may discriminate in favor of the higher-paid employees. Provisions, however, have been accepted, permitting greater employee and employer contributions for those employees who meet specified minimum age or service requirements.

Those who have not adopted the profit-sharing concept as a principle by which their business life should be governed, but who feel the establishment in the employee of an ownership interest in the employer and in its profits will create an incentive for greater efficiency, might consider a thrift plan with the requirement that participants will invest some portion of the employer and employee contributions to their credit in company stock. It does not seem reasonable that the incentive created by a profit-sharing plan as such should be greater than the incentive which can be created by making employees actual but indirect stockholders of the company.

It should be noted at this point that there is a reasonably thin line separating the thrift plan from the profit-sharing plan, and that the elements of both can easily be combined, at least mechanically. It is, however, suggested that any proposal to combine the basic features of both types of plan be viewed with skepticism.

To illustrate, perhaps beyond reason, consider a plan providing as follows: (1) that contributions to the plan will fluctuate as the employer's level of profits fluctuates; (2) that the amount of the contributions made to the plan which will be allocated to any given participating employee,

will depend upon the size of his contribution under the plan; and (3) that a portion of the funds accumulated under the plan will be invested compulsorily in stock of the employer. At this point, it may well appear that enough incentives exist with which to confuse. If the interested employee mentally stays with a description of the plan, he encounters the incentive to work hard and efficiently in order to increase the size of the company contribution. Then he finds that this in itself is not enough; there is also the incentive to be thrifty, that is, in order to participate to the maximum, he must make the maximum employee contribution. After digesting these two diverse incentives, he then finds that he wears two hats. Under one he shares in the profits of his employer and under the other he, as a stockholder, shares profits with the employees. If the experts on employee communications are correct in stating that it is difficult to make employee-benefit plans understood by employees, the presentation to employees of a plan with such diverse and, to some extent, conflicting incentives must be well nigh impossible. Seriously, it would seem that the most successful plan stresses the strongest incentive available, presents as few diverse incentives as possible and remains free of conflicting incentives.

Stock Option Plans

The rules governing the formulation of a restricted stock option plan are numerous and detailed. I do not believe anything can be gained by enumerating them in this presentation.

Stock option plans are directed almost entirely to the interest of key executives. They may be established for as few employees as the employe desires to cover. There are no rule prohibiting the employer from dis criminating among participants.

One defect in such plans is th problem involved in using them i situations wherin a clearly define market price is not available eve though a satisfactory market ma exist for the stock.

It would seem that for our pur poses, but not for those of Sectio 421 of the Code, the best measure o the amount of deferred compensatio obtainable under a restricted stoc option is the difference between th price the employee must pay unde the option and the market price o the date of exercise of the optio On and after the date of exercis the employee's status as to the stoc is not discernably different from tha of any other stockholder. For thi reason, it is obviously difficult to stat in advance the amount of deferre compensation which will be generate by a restricted stock option plan.

It would appear that restricte stock option plans have been adopte by many employers as insuranc under which the management em ployees are the named beneficiarie against being caught in a rising stoc market without a pre-existing stoc option plan in effect. If this attitu is the answer to the problem of con tinuing to be competitive in terms o retaining key executive employee this is not such a startling conclusio as it may at first appear to be.

It is, of course, possible to give a employee a bargain option. That i an option under which the purcha price is less than 85% of marke These options apparently afford som advantage when compared to r stricted stock options, in the case

esser-paid key employees. Because of he earlier incident of taxation under uch options, they are probably less ffective as a means of deferring ompensation.

'erm Insurance

Term insurance may be used to rovide a portion of the key execuive's deferred compensation. If it ; used, the key executive will be etained after retirement under the ompany's term insurance contract or an eventual death benefit equal o all or a portion of the death enefit coverage he had as an active mployee. It should be borne in mind hat the benefit payable thereunder rill, in fact, represent the cost theref to the employer inasmuch as (a) ayment is an eventual certainty, nd (b) term insurance costs are qual to the sum of the benefits paid nder the contract and the cost of dministration. As a form of deferred ompensation, post-retirement death enefits are the ultimate therein; in act, it is a form of compensation hich is as out of this world as we, s consultants, are ever likely to get. Iowever, to the extent that it augnents the employee's estate and thus rees other assets of post-death obligaions, it may be of interest to him.

There are no tax law requirements pecifying the class of employees to hich this type of benefit must be xtended. Thus, extension to limited roups is possible. However, insurnce company underwriting rules ertaining to group term insurance hich obviously prohibit the indiidual selection of the employees to e covered by such a program will ave to be met.

Deferred Compensation Contracts

Revenue Ruling 60-31 was issued by the Treasury Department early this year. This ruling eliminated to a large extent the fear that application of the constructive receipt doctrine would render most deferred compensation contracts ineffective. These contracts, as previously drawn, usually contain post-retirement service provisions intended to contradict the theory upon which the constructive receipt doctrine is based. As a means of supplementing the employer's pension plan, it originally appeared that the dollars payable under a deferred compensation contract would have to be reduced, in determining the effective value thereof, by the amount of Social Security benefit the employee would have to surrender in order to receive payment for the post-retirement services specified under the deferred compensation contract.

Under a profit-sharing plan, an employee is entitled, at least at present, to capital gains tax treatment as to the amount distributable to him under the plan if he receives it in a single tax year, and if he receives it as the result of the termination of his employment. It can be argued, and the cases appear to support the argument, that post-retirement service requirements, such as have commonly appeared in deferred compensation contracts, will make it difficult to claim termination of employment as of the date normally considered to be the date of retirement from active employment.

Presently, it seems clear that a deferred compensation contract need not specify post-retirement services. It should be possible, therefore, to eliminate from existing deferred com-

pensation contracts the source of the conflict of such contracts with the Social Security benefit eligibility rules and with the capital gain tax requirements as to termination of employment. CPAs who have clients who adopted deferred compensation contracts prior to the issuance of Revenue Ruling 60-31 should review such contracts, particularly if the client in question has a Treasury qualified profit-sharing plan.

Revenue Ruling 60-31 clearly makes it easier to establish for individual employees or for a select group of employees, contractual relationships with the employee capable of deferring both the constructive and actual receipt of post-retirement compensation.

Summary

Now to summarize at least insofar as the key executive employee is concerned.

First, the pension plan provides an advantage which is not provided by either the profit-sharing plan or the thrift plan, in that only the ultimate benefit need be reviewed as to conformity with the principles of the plan and Treasury regulations. For example, the cost of the benefit and the annual contribution required to support it need not normally be made subject to Treasury tests as to discrimination.

Second, the thrift plan and the profit-sharing plan both have limitations, when compared to the pension plan, in that the best which can be done thereunder is to increase the key employee's interest therein as to future employer contributions.

Third, the thrift plan has in most instances an advantage over the profit-sharing plan in that any broadening of the key executive's participation in the plan results in the additional cost clearly being borne by the employer rather than it being borne, in part, by other employees.

In a profit-sharing plan, it is difficult to increase the future participation of one employee without, in fact or in principle, decreasing the future participation of other employees.

Fourth, coming now to plans which are not Treasury qualified, the value of a restricted stock option as compensation can only be estimated by the accountant and his client by review of each specific case.

Fifth, the individual deferred compensation contract appears to be an excellent means of closing the gap in an otherwise incomplete picture. In this latter case the employer is enjoying the services of the executive currently while proposing, at least in part, to pay for such service at some future date. This situation is, of course, not completely within the employer's control. It is somewhat in the nature of buying the executive's services on the installment-purchase plan. However, Senator Douglas and his Committee on Consumer Credit Control notwithstanding, it would seem that this use of installment credit is subject to criticism, as is all installment purchasing, only when it is used immoderately.

The progress, problems, and future of the post audit program of the State of Illinois Agencies

The State of State Audits

ly John W. Nicholson

From the standpoint of the general ublic, the post-audits of State agenies are a measure to protect the inerests of the Illinois taxpayers. This a broad statement of the accountng profession's responsibilities; howver, it is the most succinct phrasing f the fundamental purpose of State udits that can be formulated. The llinois Auditing Act, the annual reorts of the Legislative Audit Comission, and the instructions and reorts of the Auditor General set forth ur responsibilities in greater detail. 'he more significant of these responsiilities are:

1. To determine that expenditures are made only in furtherance of authorized activities and in accordance with the appropriation acts and other applicable laws and regulations of the State of Illinois.
2. To determine that State agencies collect and account properly for all revenues and receipts.
3. To determine that assets of each agency or assets held in trust are adequately safeguarded and controlled.
4. To determine that agencies are carrying out only those activities authorized by the Legislature and that agencies are conducting programs efficiently and in the manner authorized.
5. To determine that financial reports by the agencies disclose the nature and scope of the activities conducted and provide a proper basis for evaluating the agencies' operations.

The immediately foregoing responsibilities are technical and legalistic in nature. An equally important responsibility of the accounting profession is to exert every possible effort to make the post-audit program a constructive force in the establishment of sound fiscal controls throughout the State government. The Auditor General bears the responsibility of maintaining effective working relationships with the legislature and State administrative officials concerned with over-all fiscal controls; however, each individual auditor, down to the junior doing the detail tests of transactions, has an obligation to conduct himself on his assignment in such a manner that he promotes the over-all constructive objectives of the post-audit program. The responsibility weighs heavy on each individual accountant, since the total program will be weakened if agency personnel get the impression that the accountant is part of a "Gestapo" or spy organization or that he will try to pillory them for every small error in judgment or minute departure from the statutes and regulations. While the audit reports must include disclosure of any instances of wasteful procedures, improvident expenditures, ineffectual

controls, and unbusinesslike methods in carrying out programs, each auditor should not forget that agency personnel are the individuals who will in most cases have to take the necessary action to correct deficiencies and they will have to implement the recommendations for improved procedures. An antagonistic attitude on the part of agency personnel, even with an honest purpose behind such antagonism, may negate the best of suggestions. The accountant must strive to keep from placing agency personnel in a defensive position where they feel so compelled to justify past actions that they are blinded to the positive aspects of an auditor's recommendations.

Pointing up errors and deficiencies of agencies and at the same time maintaining a cooperative attitude toward corrective action on the part of personnel responsible for such errors and deficiencies is like walking a tightrope. In every way possible, we should attempt to give the agencies the feeling that the members of the accounting profession are there more to help them with their problems rather than to criticize them for deficiencies.

Differences Between Audits of State Agencies and Commercial Enterprises

To fulfill properly our responsibilities under the State audit program, accountants must understand the character of the examinations which they undertake; and for the long-range success of the program, it is also necessary for the accounting profession to communicate to the legislators, State officials, newspapers, and others interested in State audits an understanding of the practical limitations inherent in their work.

In the early days of the accounting profession, surveillance against fraud was a major objective of all audits. To the average man on the street, the term "audit" still implies a procedure for detection of defalcations. Over the years, because of the strengthening of internal control and because the function of detecting fraud has been progressively taken over by internal audit staffs, particularly in large and medium sized companies, the independent certified public accountant has been able to direct his attention more and more to the examination of financial statements taken as a whole rather than to spend time on details.

Audits of State agencies differ from audits of commercial enterprises not so much in standards of auditing or auditing procedures as in the objectives of the engagements and the reporting on the findings developed. The expression of an opinion on financial statements is the prime and often the sole objective of an audit of a commercial enterprise. The audit of a State agency has multiple objectives, only one of which is the opinion on the financial statements.

Certain objectives which distinguish State audits from audits of commercial enterprises are largely legalistic in nature. For example, the Illinois Auditing Act provides that the Auditor General shall assist administrators of State agencies by indicating areas where their organizations are performing uneconomically or inefficiently. This would be a management service rather than an audit assignment for a commercial client. Other important objectives in State audits are to determine com-

pliance of the agency with applicable laws, regulations, and State business practice requirements. The deterrence and detection of fraud is a very significant objective of audits of governmental units that is usually considered incidental to the examination of financial statements in the commercial engagement.

The completely detailed audit must be considered obsolete as an impractical procedure in the detection of fraud. I question, however, whether it is generally understood by the public that the post-audits of State agencies are based on test procedures that cannot insure detection of all defalcations. In order to promote more sound relationships between the accounting profession and the public, an effort must be made to obtain a more widespread understanding of the limitations in this area, and while our audits should lead to disclosure of certain types of major defalcations and may give leads to the discovery of others, they cannot be relied on to uncover all classes or amounts of fraud. Types of fraud which standard audit procedures usually cannot be counted on to disclose are: collusive fraud, frauds based on false documentations, and kick-backs. Despite the foregoing comment the accounting profession is in a strong position to aid the State significantly in protecting itself from losses due to defalcations and thefts. This can be done by pointing out areas where internal controls and financial procedures should be strengthened, by encouraging the hiring of competent comptrollers and internal auditors by State agencies, and by assisting other groups in the development of more sound budgetary procedures in the State's operations.

Report Writing

The audit of a State agency, in my opinion, is primarily a procedural review combined with a special examination to act as a deterrent to fraud and to assure compliance with State laws and regulations. The certification of the financial statements is also an objective of a State audit but it is only one of several objectives. Consequently, the standard short-form opinion, which was developed by the accounting profession for reporting on examinations of financial statements, does not fulfill the needs for those parties interested in the results of State audits. It is necessary in State engagements to write a narrative report to meet the requirements of the Auditor General, the Legislative Audit Commission, and other State officials.

The writing of good comments in any audit report is a tough job. The requirements of State audits and the general political atmosphere surrounding these engagements does not make the writing of the State reports any easier. One factor that causes problems is that the auditor must often express technical matters in language which readers without accounting training will understand. In addition, he must not talk around a subject; he should not load his comments with trite, ambiguous and

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obscure words; he has important things to say and he should put forth the extra thought and effort that is necessary to communicate effectively to persons other than accountants. The auditor must develop the techniques of a good writer. If his report is indefinite or inexact, unnecessary problems may be created for the entity being audited, for himself and for others. In order to avoid such trouble, extreme care must be given to the phrasing of all comments in State reports.

The writing of a report should be a continuous task throughout an engagement. The auditor should take appropriate notes on each item which has value for his report, and he should draft his comments on the matter while he is conversant with the details of the situation. This minimizes the chance that the auditor will omit a significant comment. In addition it reduces the possibility that he will have to duplicate his review of the same point.

Recommendations should be carefully thought over and consideration given to all the procedures related to any proposed changes. Recommendations should be clear-cut and understandable to those who must consider placing them into effect. The auditor should also consider whether his recommendations strengthen controls and improve financial data for the benefit of the State and whether they justify the labor and costs the recommendations will entail. Recommendations should in all instances be reviewed with agency personnel before the draft of the report is submitted to the Auditor General.

In writing a report on a State agency, the auditor should review in particular the major comments and recommendations section of the Auditor General's most recent report. This will refresh his mind as to the more significant fiscal control measures which the post-audit program is trying to promote; it will assist in the phrasing of suggestions; and it may prove a timely reminder of a point to be included in a report that might otherwise have been overlooked. In addition, the prior reports of the agency being audited should receive careful scrutiny with attention being directed to the Auditor General's and the Legislative Audit Commission's comments on such reports. An extremely important phase of the program is the carrying forward of recommendations from report to report until each recommendation is adopted or otherwise disposed of.

In addition, the auditor should be prepared to appear before the Legislative Audit Commission (and also on the witness stand) to support the comments made over his signature.

Much of the foregoing discussion on report writing may seem elemental; however, its practical significance in communicating ideas to the legislature and State officials while also maintaining good working relations with agency personnel is extremely important.

If the accounting profession is to meet its fundamental responsibility of protecting the interests of the Illinois taxpayers and if the profession is to achieve its objective of improving financial controls in State agencies strenuous efforts will be necessary to get the message across, to be understood clearly, and to maintain effective and cooperative working relations with State employees at all levels.

TAX COMMENTS: Prepared by the Committee on Taxation of the Illinois Society of Certified Public Accountants

Qualified Profit Sharing Plans

In recent years profit sharing lans have been widely popularized nd accepted by management, emloyees, and labor unions. Individual mployees who are now beginning to eap the benefits from profit sharing lans which have been in effect for everal years are living testimonials o the many advantages of profit haring. Recently, a newspaper article noted the unusual lump sum enefit derived by an employee of a arge enterprise who received upon etirement $218,000 in a single sum rom an employer's profit sharing und, with the employee having conributed only $13,300 for the preeding eleven years.

These comments are limited to a eview of certain pertinent factors n the consideration of a qualified rofit sharing plan.

. Qualification

A qualified profit sharing plan nust meet certain requirements as rovided under I.R.C. §401 (a) (1)–6).

The plan must:

1. have a definite and written program;[1] where a trust is used as part of the program such trust must be valid under the local law as at the close of the taxable year in which the plan is in effect,[2]
2. be communicated to the employees; communication may be formal or informal,[3]
3. be permanent and continuing,
4. be designed for the exclusive benefit of the participating employees or their beneficiaries, and
5. not be discriminatory, in favor of higher compensated employees.

To avoid the risk of disqualification careful attention must be given to compliance with the Code and the applicable regulations and rulings. A recent court decision disallowed $300,000 as income tax deductions representing a company's contributions to a profit sharing plan.[4] This disallowance might have been avoided if certain minor changes in the plan had been approved by the Treasury Department.

Rev. Proc. 60–1, I.R.B. 1960–8, 26 requires that formal submission of a

[1] Reg. §1.401 (a) (2)

[2] Mimeo. 5985, C.B. 1946-172 and Rev. Rul. 57-419, C.B. 1957-2, 264

[3] Rev. Rul. 57-163, C.B. 1957-1, 128

[4] Mississippi River Fuel Corporation v. Koehler, 266 F.2d 190, (8th Cir. -1959), cert. den. 361 U.S. 827

qualified employees' compensation plan must be made for a determination by the Internal Revenue Service before a conference with the District Director's representative will be granted. However, general information regarding provisions of the Code, its Regulations or Revenue Rulings and Procedures will be given in an effort to clarify or resolve a particular problem.

2. Tax Incidence

The tax advantages of a qualified plan may be summarized as follows:

A. The employer's contributions to the trust are deductible.[5]

B. The employees' trust under the plan, by complying with the provisions of I.R.C. §401(a), §501(a) and §503(c), does not pay any tax on receipt of the contributions from the company.

C. The employees are not taxed immediately on their share of the company contributions and earnings which accumulate in the trust. The tax on this income is deferred to a subsequent period when the participants leave the employment and will presumably be in a lower tax bracket (such as at retirement).[6]

D. At the time an employee's service is terminated the amount in his account in excess of the employee's contributions that is paid to him (or his beneficiary upon his death) in a lump sum within one taxable year is taxable at capital gain rates.[7]

E. If the employee dies during the period of employment his share in the trust may be passed on to his wife without Federal estate tax (and also through his wife's estate to his children without such tax).

Thus, for stockholder—officer—employees in close corporations, particularly for those with substantial stock interests, qualified profit sharing plans present attractive tax advantages.

3. Coverage of Participating Employees

A profit sharing plan in order to qualify under I.R.C. §401(3) must benefit:

1. Seventy percent or more of all of the employees of an employing unit, or
2. Eighty percent or more of all the employees eligible to benefit under the plan providing 70% or more of all the employees are eligible to benefit under the plan.

The percentage factors do not take into account new, part-time and seasonal employees.

The Internal Revenue Service will accept a plan for a particular class of employees providing the proposed classification does not discriminate specifically in favor of supervisors, stockholders, officers or high salaried employees.[8]

4. Contributions by the Employer

Current regulations do not require a predetermined profit formula, nor need the contributions be the same amount or in the same ratio each year. There, however, should be "recurring and substantial contributions out of profits for the employees" and not "single or occasional" contributions.[9]

Although an employer is not limited in the amount he may contribute to a profit-sharing plan, the deductions for such contributions are limited for the purpose of Federal income tax to an amount not to exceed fifteen percent of the covered employees' com-

[5] I.R.C. §404 (a) (3)

[6] Rev. Rul. 60-31 clarifies the doctrine of constructive receipt as applicable to employees' benefits under non-qualified profit sharing plans.

[7] I.R.C. §402 (a) (2) and §403 (a) (2)

[8] I.R.C. §401 (a) (4); Rev. Rul. 57-163, Part 4, C.B. 1957-1, 128

[9] Reg. §1.401-1 (b) (2); Rev. Rul. 57-163, C.B. 1957-1,128

nsation actually paid or accrued ring the year.[10] In the event that s than fifteen percent is contributed any one year, the difference be- een the amount contributed and een percent of the covered em- yees' compensation may be carried ward and deducted in a subsequent ır. That difference deducted in a er year, however, must not exceed een percent of the covered em- yees' total compensation in year the carryover.[11]

Despite the fact that there may be requirement for a definite prede- mined formula, it would appear to good business practice to establish h a formula. By use of a formula, employer fixes the contribution de- ction for tax and operating pur- ses and also avoids needless mis- derstanding between the employer d employees. Consideration of a finite formula in the matter of the ertime factor may be necessary for purpose of compliance with the ovisions under the Fair Labor andards Act.

A profit-sharing formula for a com- ny's contribution should consider following factors:

(a) Precise definition of net income for purposes of the plan, describing inclusion and exclusion of certain items, for example, whether capital gain or other income not part of the normal operations of the business should be included in computing net income from which the profit sharing is derived.

(b) The portion of net income to be determined as contribution under the plan, taking into account:

1. Reasonable return on the company's invested capital.
2. Current working capital needs.
3. Contemplated capital requirements for expansion.
4. Other appropriate allowances for business purposes.

(c) Other provisions, such as reduction of employer's annual contribution by forfeitures emanating from termination of employment.

The independent certified public accountant must be aware of his role in the consideration of these factors.

The following examples describe suggested methods that may be used in determining the annual contributions to a qualified plan, with each method limited to 15 persent of the total of participants' annual compensation as provided in the Code: [12]

EXAMPLE 1

(a) No contributions need be made by the company on a designated sum, e.g. \$60,000.00 of annual net income before deduction for Federal income taxes, this sum being considered a reasonable return on invested capital, and

(b) On annual net income in excess of \$60,000.00 the annual contributions may be determined as follows:

1. 25 percent of the first \$100,000 in excess of \$60,000.00,
2. 30 percent of the annual net income in excess of \$160,000.00, or
3. Any variation thereof, as may be deemed advisable.

EXAMPLE 2

(a) 10 percent of the first \$100,000.00 of net income before taxes,

(b) 15 percent of the next \$50,000.00 of net income, and

[10] I.R.C. §404 (a) (3), Reg. §1.404 (a) (1)
[11] Reg. §1.404 (a) - 9(d)

[12] I.R.C. §404 (a) (3)

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(c) 20 percent of the net income in excess of $150,000.00.

The latter example does not give effect to a credit for a return on invested capital.

EXAMPLE 3

A percentage of the net income before deduction for income taxes, limited to an amount that will not reduce such net income after deduction for income taxes to less than 5 percent (or any other designated percentage) of the company's invested capital.

EXAMPLE 4

A percentage, e.g., 20 percent, or other designated percentage, of net income (as defined under a separate schedule).

Where an employer contribues real property instead of cash to an employees' retirement trust, there seems to be little question that the employer is allowed, for Federal income tax purposes, to deduct the fair market value of the real property under the provision of §404 of the 1954 I.R.C. However, whether or not the difference between the adjusted basis and fair market value of the contributed property is taxable to the employer, as yet, remains questionable. A U. S. District Court in Tennessee held in the General Shoe Corp. case that the difference between the fair market value and the adjusted basis of real property contributed to an employees' retirement trust by an employer was not taxable, although deduction in the amount of the fair market value was permitted. The Commissioner has appealed the decision to the Sixth Circuit, indicating a conflict of that decision with one rendered by the Second Circuit,[13] in which the difference between fair market value of the property contributed and the employer's basis was held to be taxable as a realized gain. To be able to take the fair market value of real property and perhaps other property contributed to a profit-sharing trust as an income tax deduction and by the same token to avert the inclusion as income of the difference between fair market value and the adjusted basis of the property contributed may result in additional tax advantages.

[13] International Freighting Corp. case (135 F 2d 310)

5. Contributions by Employees

Rev. Rul. 59-185 CB 1959-1, 86 permits voluntary contributions by employees limited to ten percent of the employees' compensation, to qualified pension, profit-sharing or stock bonus plans provided the employer's contributions or the benefits are not geared to employees' contributions.

The factor of ten percent of employees' compensation is an over-all limitation applicable to all qualified plans maintained by the employer. Thus, where under an existing pension plan employees may voluntarily contribute three percent of their compensation, any contributions to profit-sharing plan would be limited to seven percent of their compensation.

Taxes on an employee's share of earnings attributable to his contributed principal are deferred as are the earnings on the employer's contributions. The benefits attributable to an employee's contributions are payable to him or his beneficiaries upon his death together with the benefits from the employer's contributions. Death benefits applicable to an employee's contributions are included in his gross estate for the purpose of determining Federal estate taxes, whereas those

efits resulting from employer's tributions are not includible.[14]

Rev. Rul. 59-185 has created new portunities for savings and investnt for stockholder-executives of ll corporations under a qualified fit-sharing plan. Greater investnt and tax opportunities for emyees may develop wider employer l employee interest in profit-shar plans.[15]

Allocation of the Company's Contributions to Participating Employees

There are several methods of alloing company contributions to parpating employees. In most cases allocation is based on a formula bining compensation and years of vice, assigning a value for each to h employee, e.g.: (a) 10 units for h full year of continuous service l (b) 1 unit for each $100.00 of ual compensation not exceeding a cific sum, perhaps $15,000.00. der some plans allocations may be ed only on compensation. In the l analysis the method of allocation uld be tailored to each situation. The total units are then divided into company's contribution and each ployee's participation is the sum the number of units to his credit ltipled by the value for each unit. The factor of discrimination in alation must be carefully observed. crimination may occur in a distriion formula which considers years service.[16] A distribution formula y be deemed unacceptable if the is of distribution, whether based upon units of compensation or units of service, or any combination of both, results in discrimination in favor of a particular group of officers, supervisory personnel or stockholders. The discriminatory effect is not determined so much by the formula as by the result of its application.[17]

A profit-sharing plan will not be discriminatory if the contributions or benefits under the plan uniformly relate to the total compensation or the basis or regular rate of compensation of an employee.[18]

A provision under a qualified plan whereby funds emanating from forfeitures caused by employees' termination of service or otherwise are to be allocated to remaining participants by a method that would result in a prohibited discrimination will impair the qualifying status of the plan.[19] Allocation of forfeitures on the same basis as company contributions will avoid discrimination. However, funds arising from forfeitures may be applied to reduce the employer's contributions under the plan. Application of such forfeitures is not compulsory.[20]

A plan which excludes employees whose earnings are less than a specified amount (or includes proportionately lesser benefits for such employees) may qualify, providing the benefits under it are integrated with Social Security benefits under special rules formulated in Reg. §1.401-3 as recently amended.[21]

I.R.C. §2039 (c)

"How the new 10% employees' contributions increases benefits in profit plans" by Harold Chatterton, *Journal of Taxation,* January,), Page 17

See I.T.'s 3685 and 3686, C.B. 1944, 324 326, respectively, and P.S. No. 28, dated ember 2, 1944

17 Part 5-(.012) (a) - of the guide on "Discrimination as to Contributions or Benefits" as applicable to I.R.C. §401 (a) (4) Reg. §1.401-4; I.T. 3678, C.B. 1944, 321

18 I.R.C. §401 (a) (5)

19 Rev. Rul. 57-163 Part 5 (a) (1)

20 Part 5 - (.0122) (1) of the guide "Discriminations as to Contributions or Benefits" applicable to Reg. §1.401-4

21 In the April, 1960 issue of *The Journal of Accountancy*, pages 79 and 80, Matthew F. Blake describes methods of integrating profit sharing plans under special rulings

7. Vesting of Employees' Interests

The qualification of a plan does not require immediate vesting of employees' rights in the employer's contributions. Provisions for vesting vary. Vesting may be complete and immediate or extended over a number of years, upon the lapse of a specified number of years of service or participation, or upon the attainment of retirement age. However, in order to qualify, a plan must provide for some basis of vesting when an employee reaches retirement age or other stated age, upon the occurrence of a definitely determinable event, or upon fulfilling a length of service or participation requirement.

8. Discontinuance or Suspension of Employer's Contributions

Discontinuance of contributions to a profit-sharing plan is considered a termination of the plan even though the formalities to terminate have not been performed. A suspension, however, is a temporary cessation of contributions the circumstances of which may or may not result in a termination of the plan and may defer vesting of employees' rights in the contributed amounts. Rev. Rul. 60-2 I.R.B. 1960-1, 16 considers the problem of whether a suspension is substantially a discontinuance. In determining whether suspension of employer contributions will be treated as a termination by the Internal Revenue Service certain factors must be considered in addition to the provisions written into each plan. These factors are enumerated in this ruling.

Reasonable causes for the termination of a plan are acceptable to the Internal Revenue Service, and will not result in a disallowance of prior contributions. In the interest of the employer and employees, it is vital, however, to notify the Internal Revenue Service of such termination promptly. Rev. Proc. 56-12, CB 1956-1, 1029 describes the information to be submitted to the Service upon termination.

9. Life Insurance

Use of trust funds to purchase lif insurance protection for the benefi of an employee or his beneficiary ma constitute a distribution under th provision of Reg. §1.402 (a)-1 (a (3). Reg. §1.401-1, (b) (1) provide that any distributions under the trus must be deferred until the funds hav been accumulated in the trust for fixed number of years. Rev. Rul. 54 231, C.B. 1954-1, 150 considers "fixed number of years" as at leas two years. To make distribution prio to the accumulation of trust funds fo a fixed number of years will terminat the exempt status of a qualified trus However, if life insurance is pur chased with trust funds accumulate after a fixed number of years (two o more years) such "distribution" wi not impair the tax exempt status of qualified plan. The purchase of lif insurance must be incidental to o subordinate to the major purpose o the plan.

Funds invested in paid-up units o endowment insurance (under certai provisions of Rev. Rul. 60-83, I.R.B 1960-10, 9) will not impair the ta exempt status of the trust if the lif insurance element does not continu beyond retirement.

A lump sum distribution may b made to an employee upon termina tion of service and such lump su credited to his account may include

ıid-up life insurance contract acıired for an employee's benefit. Rev. ıl. 60-84, I.R.B. 1960-10, 11 prodes that although the paid-up life surance was not converted (in that portion of the insurance protection ntinues beyond the employee's reement) that factor in itself will t impair the tax-exempt status of e trust.

This ruling provides further that a mp sum distribution which includes ıid-up life insurance will be subject capital gain treatment if the emoyee does not convert the life inrance into an annuity contract thin 60 days after the policy is ceived in distribution.

). Purchase of Employer's Stock

Provisions of the Code limit the instment by the profit-sharing trust stocks and other securities of the ıployer. Full disclosure of such instments tto the Internal Revenue rvice is required.[22] Where the trust cument and local law permit the vestment of trust funds in the stock securities of the employer and prode that such investments do not imir the benefits to the employees or eir beneficiaries, such investments trust funds is permissible under R.C. §401 (a) and §501 (a) proded further that these investments not constitute prohibited transacıns under the I.R.C. §503.[23]

Caution should be exercised to avoid ax-exempt profit-sharing trust from gaging in a business activity that uld result in unrelated business inme within §513 (b) of the 1954 R.C., thus disqualifying a trust as x exempt. Rev. Rul. 60-206 I.R.B. 1960-21, 10 declared that the rental income from the leasing or renting of railroad tank cars is an operation for profit, the income of which is considered unrelated business taxable income, and not within the exception of I.R.C. §512 (b).

11. Employee's Estate

Though the exclusion of an employee's portion of profit-sharing benefits from an employee's estate are attributable to employer's contributions, benefits applicable to an employee's contributions are includible in the participant's estate.[24] It may be advisable to make death benefits arising from a profit-sharing trust trust payable to a participant's personal trust. This procedure, if properly followed, can provide for the retention of profit-sharing benefits intact for a wife, without taxation of these benefits in the estates of the wife or husband.

In the event of the death of a participant under a qualified profit-sharing plan, amounts received to the extent of $5,000.00 attributable to employer's contribution are tax exempt.[25] It should be noted, that to take advantage of this exemption where an employee has acquired a vested interest in the distribution immediately prior to date of demise, the whole sum must be distributed within one taxable year of the distributee.

12. Subchapter S Corporations

There is the possibility from current reports that the Treasury Department may seek to amend Subchapter S to eliminate pension and profit-sharing benefits to stockholder-employees of Subchapter S corpora-

[22] Reg. §1.401-1 (b) (5); Rev. Rul. 57-163, rt 2 (k) (1), C.B. 1957-1, 128, I.R.B. 1957-10

[23] Rev. Rul. 57-163, Part 2 (k)

[24] I.R.C. §2039 (c)

[25] I.R.C. §101 (b)

tions who own five percent or more of the shares of stock in such corporation. This proposed action is premised on the fact that a Subchapter S corporation is, for tax purposes, considered a partnership or sole proprietorship. Such amendment would have a considerable impact on small and medium sized closed corporations.

Profit-sharing plans have not been limited to large business enterprises. Such plans also have become significant in the operation of medium sized businesses. It is incumbent upon the independent certified public accountant to become thoroughly familiar with all tax aspects of this form of deferred compensation arrangement.

AS WE GO TO PRESS

ACCOUNTING RESEARCH

Shortly before August 1 Maurice Moonitz assumed his duties as Director of Research of the American Institute of CPAs' newly expanded research program. By this date considerable progress has been made on each of the projects under investigation—accounting postulates, accounting principles, accounting for income taxes, accounting for business combinations, accounting for leases, and accounting for non-profit organizations. While several previous pleas have been made for members of the Institute and the various state societies to convey their thoughts on these areas to the research director, it would seem even more appropriate now that the projects are well under way for each member of the Society who has an interest in any of these areas to spend a few minutes to put his thoughts into writing and send them to Mr. Moonitz at the Institute offices in New York.

RECOGNITION OF AN ACCOUNTANT

One of the feature articles in the August, 1960, issue of **FORTUNE** has some very interesting and complimentary comments to make regarding one of the Society's favorite sons. In "A Notable Fiscal Recovery" the role played by Maurice Stans, as well as other Treasury and Budget officials, in strengthening the Federal government fiscal system is highlighted. The article is highly readable and very timely.

READER REACTION

In the Summer Issue of THE ILLINOIS CPA readers were invited to cmment upon "our new look," our new format, cover design, new official name, and other new or changed aspects of the quarterly. Likewise, readers were invited to submit Letters to the Editor on timely matters pertaining to the profession or on previously published articles. As we go to pres we must report that it has **not** been necessary to employ additional secretarial help to process the correspondence received. Once again, your comments, suggestions, opinions and reactions are solicited.